DOW THEORY LETTERS INC.

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P.O. Box 15196
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40 Letters per Year — $50.00 Annually

Registered with the Securities Exchange Commission

September 28, 1965 Letter 301

THE MARKET: In recent Letters I have discussed "the final blow-off theory" regarding this market. Judging from recent action, we can now say that the market is changing that "theory" into reality. With the advance-decline ratio up on 36 of the last 43 trading days, with total N.Y.S.E. volume running between 6 and 9 million shares per day on 15 out of the last 16 days, there is little doubt that the market is "blowing" like a locomotive with a double load of coal.

Only one element is missing and this omission constitutes one of the main topics of conversation among analysts throughout the nation. "Glamour stocks" are rocketing, volume is surging, boardrooms are full, and, in fact, it looks like 1961 all over again (but bigger). The question is — where is the odd-lot public? Not only is the public reticent as evidenced by steady odd-lot selling, but odd-lot volume as a percentage of total N.Y.S.E. volume is holding at the historically low level of around 7%. This fact plus the historic high in the short interest total on the Big Board have been the technical mainstays of the bull camp. Will the short interest shrink as the market rises and will the public finally find Wall Street irresistible? As a guess (see last Letter) I do not think so. Normally, odd-lotters tend to step up selling (or decrease buying) during a rise, and it is probable (as in 1962) that the odd-lotters will not switch to buying until this market actually turns down. The short interest constitutes an even bigger puzzler, and it may be that just as the short interest dropped during the May-June decline (shorts apparently covered as the market tumbled), it is possible that short interest here will not recede until the market itself turns down.

But — what if the market does continue to rise until at least the odd-lotters reverse to the buying side? What if the market does climb steadily until the short interest simply does decline? In that case we are apt to see a continuing blow-off that will dwarf anything seen in a generation. But I would not want to count on this, and here is why.

The twin premises of expanding business (due to Vietnam or what have you) and inflation are the fundamentals which are being used to justify this rise. But the first premise is questionable and is discussed in the bank credit section of this Letter. The inflation premise is far from assured, due to rising money rates here, which in turn are bolstered by high interest rates and deflationary fiscal policies abroad (see later comments).

Thus, in my opinion the vacuum being created by the technical performance of the market and the fundamental position of the economy have created a stock market which is extremely dangerous. As far as my subscribers are concerned, I continue to say that I would rather you watch it than play it.

On September 21 the Rail Average rallied above its August (219.18) peak, thus eliminating a divergence which had been in effect for almost a month (see Chart 1). The new Rail high came during a dramatic week which saw volume surge to 40.9 million shares, largest weekly volume since July, 1933. The week ended with 729 issues down and 655 up, but the surge in Rails brought the two Averages within easy striking distance of the 1965 highs.

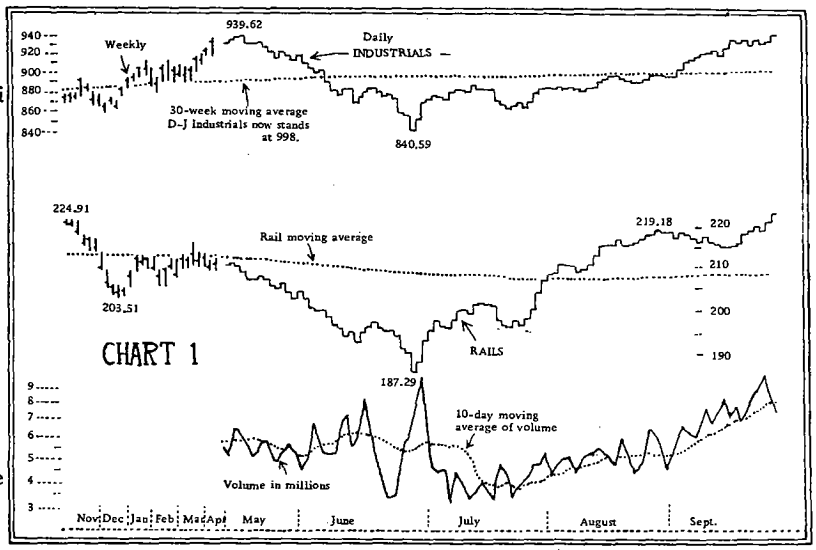
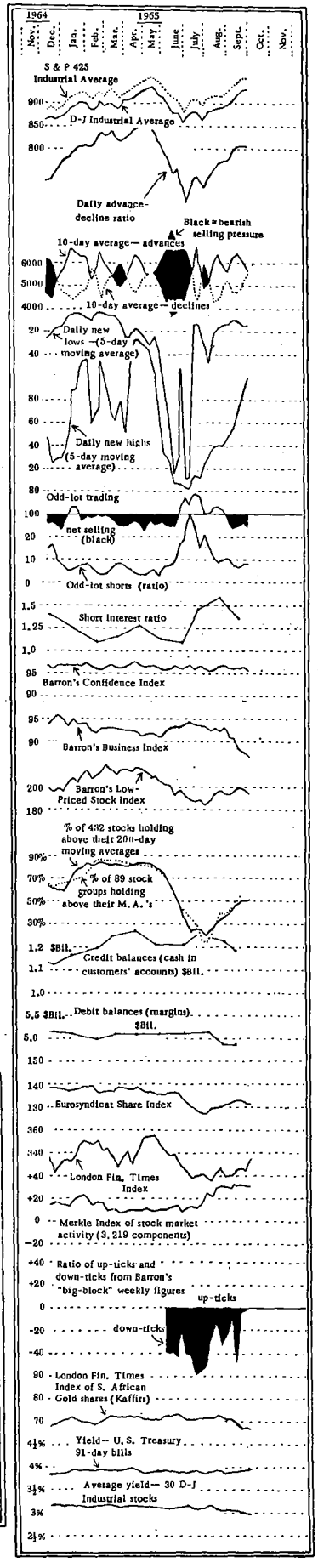


CHART 1


1964
1965
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving average)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

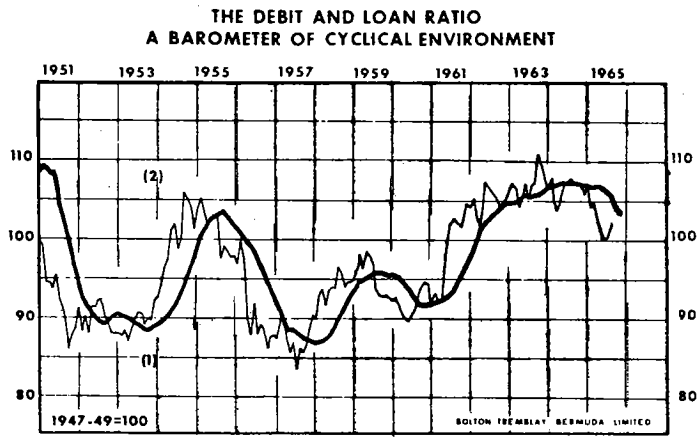
Question: What would you say if the two Averages advanced to new bull market highs, Rails above 224.91 and Industrials above 939.62?

Answer: My calling of a bear signal in June of this year was predicated on my interpretation of an October-December (1964) secondary reaction, a subsequent rise to new highs by Industrials (unconfirmed by Rails), and then a breaking of the December lows by both Averages (the latter being the bear signal). If the two Averages now go to new highs, it would constitute a reconfirmation of the primary bull trend, and in this case my bear signal classification would obviously have been in error. How could this error have occurred? If I was wrong it was probably in my labeling of the October-December decline as a full secondary reaction. Actually, in point of time the October-December movement fit the requirements for a secondary as did the decline in Rails. I stated at the time that the decline in Industrials was "subnormal" in extent, but I nevertheless thought it was sufficient to allow me to label the whole movement as one of secondary proportions. If the Averages now go to new highs, my error would have been in classifying a decline as a full secondary reaction. It takes the breaking of full secondary low points to signal a bear market, and this is why the classifying of reactions and declines is so important.

Question: Wouldn't it be very bullish and a prediction of much higher prices if both Averages now rallied to new bull market highs?

Answer: Successive penetrations in a bull market carry decreasing validity. Thus, there must be a final "bullish penetration" before the market hits its ultimate peak. With the 10-day average of N.Y.S.E. volume now running over 7 million shares (!) and with Wall Street frothing with excitement, anything can happen, but I would consider new highs on the Averages at this time a tenuous excuse to speculate in this market.

STOCK MARKET AND BANK CREDIT: One of the studies which Mr. A. Hamilton Bolton ("Bolton Tremblay Bank Credit Analyst," 1245 Sherbrooke St. West, Montreal 25, Canada) has developed for gauging the progress of the business cycle is the debit/loan ratio (see chart). The debit/loan ratio measures the flow of money in the economy in relation to the shortest term liabilities (debts) of the economy. For the "flow of money" Bolton uses bank debits (or transactions at the banks) at 225 areas, and these debits are considered an accurate measure of all activity in the economy. For "loans" Bolton uses seasonally adjusted commercial and industrial loans over the same (monthly) period.



(1) 3-month Average Bank Debits (S.A.) as a % of latest month's Commercial and Industrial Loans (S.A.)
(2) 10-month Average of ratios in (1) advanced 3 month's into future.

Thus Bolton sets up the whole nation in the form of a single "national corporation." The rationale for this study is both simple and valid. If an individual business is expanding at a 10% rate (which is approximately what the U. S. is doing now) but borrowing at a 20 to 25% rate (which is what the U. S. is doing now) it will only be a matter of time before the business finds that it is "over-borrowing" and "over-inventorying" in relation to its sales. History shows that when this situation exists, a slow-down in sales will shortly occur. The sales slow-down will in turn tend to upset inventory projections (which had been based on higher sales forecasts). Next there will be a period of involuntary inventory build-up and involuntary bank borrowing (to finance the inventory build-up). All of which is calculated to cause a good deal of damage in the economy, and such conditions are usually discounted by a declining trend in stock prices. This whole process comprises the period which Bolton has labeled the "boom break-up."

Bolton uses a number of criteria in "reading" his debit/loan ratio; these criteria are based on the positions of moving averages of the debit/loan ratios. Without going into the technical "signals" involved, it is sufficient to state that the debit/loan ratio turned unfavorable in June of this year (see chart), and it has continued unfavorable to the present.

"The debit/loan ratio," says Bolton, "has an uncanny way of anticipating both the peak in business and its subsequent trough. It does this sufficiently in advance too that it tends to lead the peaks in stock prices which themselves lead the peak in business. Similarly, the D/L ratio tends to lead both the stock market and business on the up-side."

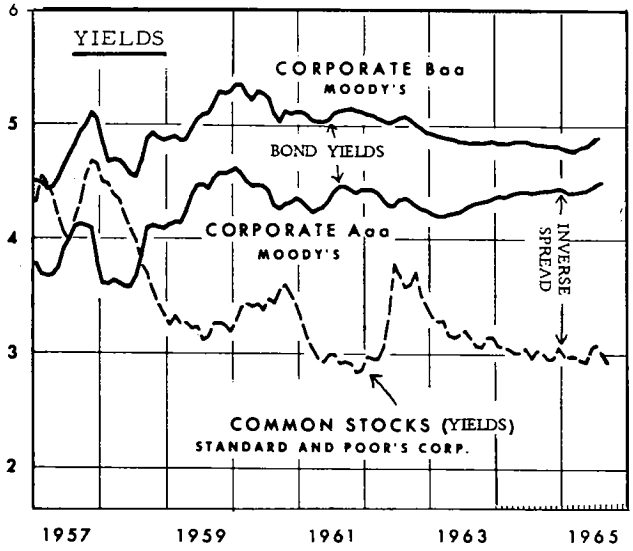
Bolton has noted that the current period of the Vietnam war resembles in some respects the earlier periods of 1939-41 (the interim period of World War II) and the period of 1950-51 (the buildup period of the Korean War). Nevertheless, he comments that the Vietnam War will probably not exert the same upward push on the U. S. economy which the 1939-41 and 1950-51 periods provided. This is particularly true since the U. S. economy is so much larger now than it was during those two earlier war periods.

Bolton also states that during 1939-41 there was little or no price inflation built into the stock market and that in 1950 we were close to the greatest period of stock undervaluation in modern history (both periods must be contrasted with today's high stock market, low yields and long stretch of economic expansion). Despite this, it is worth noting that during 1939-41 and 1950-51 the stock market went into important declining phases, and it did not turn up again until the debit/loan ratio also reversed its unfavorable pattern.

* * * * * *

To discuss the money market further, it is important to remember that sooner or later all market instruments adjust to yield or the return on investment. This is just as true of the "growth stock" which will adjust to the investor's appraisal of future earnings and dividends as it is of the bond which will adjust to the quality of the individual bond and to the prevailing interest rates in the money market.

The relationship of the yields on stock and bonds is never an exact one. Nevertheless, consciously or unconsciously large investment interests are always aware of the spread between average stock and bond yields. This is true because except in extreme circumstances (such as periods of rampant inflation) there comes a point where current bond yields may be more attractive than the possibilities or hopes of a rise in stock prices (and the accompanying expectations of increased dividends). The present period may well be one in which a declining trend in bonds (with rising bond yields) begins to exert pressure on a stock market which is and has obviously been discounting both rising earnings and dividends and inflation.



The unfavorable or inverse spread between bond and stock yields is now becoming acute, and this is documented in the accompanying chart (from the Federal Reserve Chart Book). Here we note that the spread between the yield on the S & P 425 Industrial Index (2.87%) and AAA corporate bonds (4.51%) is the greatest in modern history. Furthermore, it is well to note that yields on long-term U. S. Treasury bonds are at the 4.29% level, highest level in five years (see Letter 300). Last week the D-J Municipal Bond Index (tax-free) rose to 4.43%, highest yield in three years, while yields at last week's auction of the very sensitive 181-day Treasury bills climbed to 4.06%, highest since February, 1960. Thus bonds, notes and bills are now providing bargain yields in the face of extremely thin yields in the stock market. The argument for stocks is thus reduced to (1) growth and (2) inflation. But in the face of Bolton's debit/loan ratio, these two arguments become tenuous or at best suspect (at least for the time being).

Other factors must also be considered. If the Vietnam war is to continue, and if inventories are to expand and if consumers are to continue their spending spree, then the pressure for new money is going to intensify. This pressure will be aggravated if the widely-predicted capital goods boom takes place in 1966. All of this will tend to drive bond prices down even further — it will also tend to push bond yields up.

Can the stock market continue to rise in the face of the competition of higher interest rates? The answer is that it can, but in this writer's opinion such a rise at this stage of the cycle is apt to take the form of a "flag-pole on top of the mountain," or a speculative "blow-off" in stocks. The rise on the N.Y.S.E. has assumed many of the aspects of a blow-off during August and September. If it continues from here it will appear even more speculative and more dangerous. Should one be in this type of a market? Should one skate on thin ice? It all depends upon how wild one is for the skating game.

The Composite Chart shows the two leading industrial averages literally at their 1965 highs. The advance-decline ratio has tended to "flatten out," and the 10-day averages of advances and declines are almost in equilibrium. New highs (5-day av.) went above 100 this week, a bullish showing. Odd-lotters continue to sell on both advancing and declining days, a bullish reaction. The short-interest ratio for September dropped to 1.35 because of high volume, although the short interest rose to a record 7.7 million shares. Barron's Confidence Index, after topping out on the week of November 27 at 97.7, this week broke to a new low of 95.6, thus completing an enormous and bearish top. The percentage of stocks holding above their moving averages rose to 51%, which is bullishly above 50% for the first time on this rise. Credit balances dropped this month, implying that the little fellows are coming into the market (since they are using up their cash balances). Debit balances sustained a minor rise, but are still bearish because they have been in a major declining phase since November, 1963. The Merkle Index (computed by my friends at Traders Research) is still bullish at plus 32, and this Index has proved to be an excellent over-all technical indicator. Reflecting the new-found hopes for the pound, the British market is up and the Kaffirs continue their dragging decline. Big-block downticks outnumber upticks by 5 this week, putting the ratio at minus 3. With a new high yield of 3.98%, the 91-day bills yields are now bearishly above the average yield (2.99%) on the D-J Industrials by the huge adverse spread of 1%. Conclusion: Market action

WHAT THEY'RE SAYING: Following is the periodic review of current professional opinion from a few of the many services received here each week (refer to Letter 292 for the last summary).

Garfield Drew (Drew Odd Lots) "So far, the indicated trend still points higher and no signs of internal weakness are evident. The usual longevity of such advances and seasonal influences suggest the development of a top within the next few weeks, but until there are some concrete indications, the path of least resistance is assumed to be up."

Don Worden (Worden Tape Studies) "We now regard all trends as up — short, intermediate and primary. The short and primary trends are perhaps the most vulnerable at this time since the market is flirting with a new high. It is quite possible that we might experience a temporary retreat before the upthrust into new high ground. At this time the odds are overwhelming that a new high will be attained."

E. George Schafer states: "The increasing tempo of speculation in this market, the new monthly high in trading volume .... and the new all-time high in the short interest — have prompted me to raise my 'danger area' to the 960-995 area for the Industrial Average, and to extend the final topping out period well into the Spring of 1966."

Joseph Granville: "Every major technical indicator points towards the new highs ahead, with or without any brief technical reactions."

James Dines believes the market has been forming a broad trading range within 50 points each side of 890. "We believe that this broad lateral motion, in retrospect, will be seen to have been a top. In other words, we are not fighting the present uptrend, but instead are going along with the broader trend of lateral motion."

Indicator Digest from a special "late flash": "...our Short-Term Indicator charts... rendered a short-term "Sell" signal simultaneously with the new "Buy" signal referred to in our Composite. This seems contradictory, but it is not unprecedented — one set of Indicators refers to the major trend, the other to the secondary trend which often goes opposite to the others."

suggests a continuation of the upsurge, but such indicators as the Confidence Index, big-block downticks and adverse yield spread continue to say that this is a dangerous market.

Late Market Notes: On Monday (September 27) Industrials closed at 937.88 with an inter-day high of 944.74. As seen on Chart 2 below, this approximately equals the preceding May high although on a closing basis the Industrials halted 2 points from the old high. Nevertheless, the violence of the action since point 3 (May) can be appreciated when we realize that the Industrials have now travelled 200 points (100 down and 100 up) within a period of 19 weeks. Point 5 on the huge "broadening pattern" (which was discussed in Letter 299 and 300) is now in the process of materializing. This is one of the most incredible structures in the history of the Averages, and it will be fascinating to see how it is resolved.

PRICE OF GOLD: With the U. S. and the International Monetary Fund working on the problem of "greater world liquidity," with a rising stock market and with England "out of the woods" as far as the pound is concerned, few people have been following the dollar price of gold. Yet this is the best gauge of world opinion regarding the dollar. Since by definition a dollar is 15 5/21 gold 9/10 fine, any rise in the price of gold in terms of dollars is a drop in the value of the dollar. As the chart below shows, the first big rise in the price of gold ended last March at around $35.018 per ounce of gold. The price then broke and touched a low in June. A new rise took the price of gold to a new high in August, followed by a new drop, this time to the $35.010 level. Since then the price of gold has been quietly rising to last week's high of $35.015. This is only a few cents from the level which six months ago was considered dangerous speculation against the dollar. It will be worth watching the gold price (quoted daily in the Wall Street Journal) carefully from here on. This is doubly true since there is so little talk about the gold price now. In the meantime, the 10 to 15% hedge in gold shares which I have been advocating should be held intact.

SUNDRY NOTES: Much publicity has been given to Secretary Fowler's recent European trip. The expressed purpose of the trip was to stimulate central bankers in Europe to start thinking about the problem of "international liquidity." The U. S. has a problem. Before leaving, Fowler stated the problem as follows: "If we allowed our payment deficit to continue ... we would undermine world confidence in the dollar and impair its usefulness as a world reserve and leading currency. Dollars would return to our shores as claims on our gold ... We must reach and maintain equilibrium in our foreign payments as a matter of highest priority."

But here comes Congress voting $7.5 billion for foreign aid, the Vietnam war is costing more, Great Society legislature is flooding the nation with dollars. Noting this Fowler has had sense enough to warn that the second half of 1965 may see our foreign payments in the red again.

What to do? If we continue to run deficits, we will continue to lose gold. In other words, Fowler knows that the dollar alone cannot supply the continuing deficits and liquidity needed for world commerce. The major problem stems from the fact that the great majority of free nations (about 70) are tending towards socialism and inflation. These nations are steadily losing hard money due to inefficiency and capital flight. It is these nations that need the liquidity now being enjoyed by such advanced nations as France, Germany and Holland.

So Fowler must go where the liquidity is, and that is to Europe. As economist Melchior Palyi put it: "Folwer's mission was understood to be an attempt to sell the Continental hard-money managers on the idea that they should put up their gold in order to cover the deficits of the prodigal nations, thereby to relieve the pressure on the dollar." (from the Chicago Tribune, Sept. 14).

Will the European nations go along with the Fowler plan? This observer believes they will not. A second reason (some say it was the main reason) for the Fowler trip was to arrange another loan to Britain in the current all-out attempt to get the pound through the Fall. The results of the British operation may be a harbinger of the type of cooperation we can expect in the future. The latest British "rescue operation" was described by my friend Harry Schultz in his report of September 14: "The pound continues to flounder. Last week's new British loan was a desperation operation. They could only raise some $800 million, and were ashamed to announce the actual amount. The U. S. had to put up one half of it, and it was a U. S. promotion. There were only nine other countries who would go along, plus the International Settlements Bank — which means that each would only put up $40 million, not much of a display of confidence in the pound. It's the weakest show of financial cooperation to date, involving the smallest amount of money and least amount per country. The joke is that Fowler called it a move from strength, not from weakness, and some unlearned observers called it a strengthening of the pound when it only represents getting deeper in debt. The rescue operation has gone the limit."

Conspicuous by its absence from the loan group was France. The New York Times (September 13) described France's position this way: "The French argument on financial grounds is that this deal, like the several preceding deals, was a hopeless case of throwing good money after bad. The fault, in official French views, lies with the present monetary system and the special status of the dollar and the pound. To some French abservers, in fact, the new deal is really a deal to save the dollar by sparing Britain the need to sell its $1.25 billion portfolio of American securities."

SIMULTANEOUS PENETRATION: As this Letter is concluded (Tuesday, Sept. 28, after the opening) the two Averages are in the process of pushing through to new highs on the same day. This simultaneous penetration is rarely seen, and it is usually a "prediction" of a more forceful follow-through than would be the case if the two Averages rose to new highs say a few weeks apart.

At the end of the first hour the new electronic tape on the N.Y.S.E. was running "late" (which it only does if volume is moving at a rate of 10 million or more per day!), and Rails were above their 224.91 high. Industrials were up about a point and not yet clearly "moving out." In all a difficult time to end this Letter, but if, by today's closing, the two Averages are at new highs, we may be treated to some of the wildest action in many a year.